DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER 06-0023
GROSS INCOME TAX FOR THE REPORTING PERIODS COVERING THE CALENDAR YEARS 2001-02

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ISSUE

I. Gross Income Tax—Deductions—Bad Debts—Calculation

Authority: IC 6-2.1-4-2 (1998) (repealed 2003); IC 6-2.5-6-9 (1998) (current version at *id.* (2004)); IC 6-8.1-5-1(b) (2004); *Ind. Dep't of Rev. v. 1 Stop Auto Sales, Inc. (1 Stop Auto III)*, 810 N.E.2d 686, 690 (Ind. 2004), *rev'g partial grant of reh'g sub nom. 1 Stop Auto Sales, Inc. v. Ind. Dep't of State Rev. (1 Stop Auto II)*, 785 N.E.2d 672, 674 (Ind. Tax Ct. 2003); *State Bd. of Tax Comm'rs v. New Castle Lodge # 147, L.O.O.M.*, 765 N.E.2d 1257, 1264 (Ind. 2002); *Middleton Motors, Inc. v. Ind. Dep't of State Rev.*, 380 N.E.2d 79, 81 (Ind. 1978); *Hoogenboom-Nofziger v. State Bd. of Tax Comm'rs*, 715 N.E.2d 1018, 1024 (Ind. Tax Ct. 1999); 45 IAC 1.1-4-2 (2001)(repealed 2003)

The taxpayer argues the field auditor erred in adjusting its bad debt deductions by using figures from the taxpayer's federal corporate income tax returns for total sales as the denominator in the Indiana-to-total sales ratio.

STATEMENT OF FACTS

The taxpayer consisted of a foreign holding company (hereinafter "the parent") and three of its foreign subsidiaries. During calendar years 2001-02 (hereinafter "the assessed years") the taxpayer operated a chain of health spas throughout the United States, including Indiana, as well as in one city in Canada. The taxpayer filed consolidated Indiana returns for the former gross income tax ("GIT") for both of these years.

One of the subsidiaries (hereinafter "the Ohio subsidiary") was chartered in Ohio but had Indiana operations during the assessed years and operated an Ohio/Indiana division. The Ohio subsidiary was unable to collect on some of the spa contracts it entered into with individuals residing in Indiana. The taxpayer took bad debt deductions for these uncollectible sums on its returns for the assessed years. It arrived at these deductions by using the ratio of all of the Ohio subsidiary's bad debts incurred by the Ohio/Indiana division by total sales of that division.

The Audit Division of the Department conducted an audit of the taxpayer for calendar years 2001-03 for all types of Indiana income tax liabilities, including GIT. The field auditor made no adjustment for calendar year 2003, but did adjust the GIT liabilities for 2001 and 2002. Specifically, the auditor reduced the bad debt deductions for each year by calculating a bad debt allowance in the ratio that Indiana-allocated sales bore to total sales as shown on the federal return for that year. The audit, after certain further adjustments for 2002 not in issue here, generated low four-figure GIT deficiencies for both years. The Audit Division issued Notices of Proposed Assessment of GIT to the parent on behalf of the taxpayer for these deficiencies. The Department will provide additional facts as needed.

DISCUSSION

A. TAXPAYER'S ARGUMENT

The taxpayer argues that the auditor erred in calculating the bad debt ratios by dividing each year's Indiana sales as reported in its general ledger by total sales as reported on the federal return for that year. The taxpayer contends that the auditor's using this calculation distorted its income because it had large revenue adjustments on Schedule M-1 of each federal return. Lastly, the taxpayer submits it would have been more appropriate for the auditor to use total book sales as the denominator instead.

B. ANALYSIS

The former Gross Income Tax Act of 1933, chapter 50, 1933 Indiana Acts 388, formerly codified as amended at IC article 6-2.1 (1998), and its implementing regulations, formerly codified at 45 IAC article 1.1 (2001), were both repealed effective January 1, 2003. Before that repeal, the act provided that "[e]ach taxable year, a taxpayer that reports his gross income on an accrual basis is entitled to deduct bad debts from his gross income in the same manner provided in IC 6-2.5-6-9." IC 6-2.1-4-2 (alteration added).

IC 6-2.5-6-9 (1998) (current version at *id.* (2004)) is a gross retail (sales) and use tax statute. It provides a deduction for receivables which "were written off as an uncollectible debt for federal tax purposes under Section 166 of the Internal Revenue Code [I.R.C. (26 U.S.C.) 166] during the particular reporting period." IC 6-2.5-6-9(a)(3) (alteration added). The GIT regulation that implemented former IC 6-2.1-4-2, former 45 IAC 1.1-4-2 (2001), was to the same effect. The Indiana Supreme Court has held that "the bad debt deduction [to] which [a taxpayer is] entitled [under IC 6-2.5-6-9 is] "limited to that portion of the amount of its receivables equal to the amount written off for federal income tax purposes." *Ind. Dep't of Rev. v. 1 Stop Auto Sales, Inc. (1 Stop Auto III)*, 810 N.E.2d 686, 690 (Ind. 2004) (alterations added). In so holding, the court reversed the Indiana Tax Court, which had held in an opinion partly granting rehearing that "for the purposes of Indiana's Bad Debt statute, [a taxpayer] may deduct an amount equal, in part, to the amount of its uncollectible Indiana receivables it removed from its books as a loss for federal tax purposes, not merely the amount it deducted as federal bad debt." *1 Stop Auto Sales, Inc. v. Ind. Dep't of State Rev. (1 Stop Auto II)*, 785 N.E.2d 672, 674 (Ind. Tax Ct. 2003) (alteration added), *rev'd by 1 Stop Auto III, supra*.

It is clear in light of *1 Stop Auto III* that the taxpayer erred in preparing its 2001 and 2002 Indiana returns. In addition, *1 Stop Auto III* further shows that the taxpayer's present argument is wrong. The ratio of Indiana-allocated to total sales shown on its books for 2001 and 2002 is not the correct measure of its deductions for those years. Instead, the respective amounts of Indiana-allocated bad debts the taxpayer actually deducted on each of its federal returns for those years are the amounts of the deductions to which it was and is entitled.

The taxpayer did not cite to any legal authority to support its protest, and in particular did not argue *1 Stop Auto III*. The Department infers from this circumstance that the taxpayer did not know about *1 Stop Auto III*. This apparently would explain why the taxpayer also has submitted no records or other evidence to support its protest by documenting the respective amounts of Indiana-allocated bad debts it actually deducted on its 2001 and 2002 federal returns. Nevertheless, the taxpayer was chargeable with constructive knowledge of *1 Stop Auto III* and therefore should have submitted such evidence if it wanted to rebut the proposed assessments. "All persons are charged with the knowledge of the rights and remedies prescribed by statute." *Middleton Motors, Inc. v. Ind. Dep't of State Rev.*, 380 N.E.2d 79, 81 (Ind. 1978). "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. *The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made*." IC 6-8.1-5-1(b) (2004) (emphasis added).

Indiana law is settled that this state's taxation hearing officers, and by extension the state-level taxing authorities of which they are agents, "do not have the duty to make a taxpayer's case." *Hoogenboom-Nofziger v. State Bd. of Tax Comm'rs*, 715 N.E.2d 1018, 1024 (Ind. Tax Ct. 1999), *cited with approval in State Bd. of Tax Comm'rs v. New Castle Lodge # 147, L.O.O.M.*, 765 N.E.2d 1257, 1264 (Ind. 2002). The Tax Court stated the rationale for this rule in *Hoogenboom-Nofziger* as follows:

> [T]o allow [a taxpayer] to prevail after it made such a cursory showing at the administrative level would result in a tremendous workload increase for [the Department and] the State Board [now the Indiana Board of Tax Review], … administrative agenc[ies] that already bear[ ] … difficult burden[s] in administering this State's [listed and] property tax system[s]. If taxpayers could make a de minimis showing and then force [the Department or] the State Board to support its decisions with detailed factual findings, the [Indiana taxing authorities] would be overwhelmed with cases such as this one. This would be patently unfair to other taxpayers who do make detailed presentations to the [taxing authorities] because resolution of their appeals would necessarily be delayed.

715 N.E.2d at 1024-25 (alterations added).

FINDING

The taxpayer's protest is denied.

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